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Before the  
**FEDERAL COMMUNICATIONS COMMISSION**  
 Washington, D.C. 20554

FCC 95-49

In the Matter of )  
 )  
 Price Cap Performance Review )  
 for Local Exchange Carriers; )  
 Treatment of Video Dialtone Services )  
 Under Price Cap Regulation )

CC Docket No. 94-1

**FURTHER NOTICE OF PROPOSED RULEMAKING**

Adopted: February 7, 1995 Released: February 15, 1995

Comment Date: April 17, 1995  
 Reply Comment Date: May 17, 1995

By the Commission:

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## I. INTRODUCTION

1. In 1992, the Commission modified its rules to permit Local Exchange Carriers (LECs) to offer video dialtone service.<sup>1</sup> In formulating rules to govern the provision of video dialtone, the Commission considered whether additional regulatory measures were necessary to guard against cross-subsidization and other anti-competitive practices by telephone companies offering video dialtone service.<sup>2</sup> In the *Video Dialtone Order* and the *Video Dialtone Reconsideration Order*, the Commission noted that several parties had contended that the existing safeguards against cross-subsidization should be strengthened by adopting rules specifically designed to identify and prevent cross-subsidies in video dialtone offerings.<sup>3</sup> Several parties specifically proposed that the Commission establish a separate price cap basket for video dialtone services.<sup>4</sup>

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<sup>1</sup> See Telephone Company-Cable Television Cross Ownership Rules, Sections 63.54-63.58, Further Notice of Proposed Rulemaking, First Report and Order and Second Further Notice of Inquiry, 7 FCC Rcd 300 (1991), *recon.*, 7 FCC Rcd 5069 (1992), *aff'd sub nom.*, National Cable Television Association v. FCC, 33 F.3d 66 (D.C. Cir. 1994); Telephone Company-Cable Television Cross Ownership Rules, Sections 63.54-63.58, Second Report and Order, Recommendation to Congress, and Second Further Notice of Proposed Rulemaking, 7 FCC Rcd 5781 (1992) (*Video Dialtone Order*), *appeal pending sub nom.*, Mankato Citizens Telephone Company, No. 92-1404 (D.C. Cir. filed Sept. 9, 1992) and *modified on recon.*, FCC 94-269, \_ FCC Rcd \_ (rel. Nov. 7, 1994) (*Video Dialtone Reconsideration Order*).

<sup>2</sup> For example, telephone companies could engage in cross-subsidization and predatory pricing by setting rates for their video dialtone services below their incremental costs and recovering such costs from telephone ratepayers. Under price cap regulation, a carrier's ability and incentive to shift costs from one service to another is restricted by the grouping of services into baskets, each subject to its own price cap. Whenever a set of rates is subject to a price cap, carriers have no incentive to shift costs into the basket because the cap does not move in response to endogenous cost changes.

<sup>3</sup> See *Video Dialtone Order*, 7 FCC Rcd at 5824-27; *Video Dialtone Reconsideration Order* at paras. 157-60.

<sup>4</sup> See, e.g., American Telephone & Telegraph (AT&T) Comments at 12-13 (filed Jan. 23, 1992); Pennsylvania Office of Consumer Advocacy (POCA) Comments at 23-25 (filed Jan. 23, 1992); United States Small Business Administration (SBA) Comments at 34-35 (filed Jan. 23, 1992) in *Video Dialtone Order* at para. 86 n.223 (requesting clarification that a separate price

2. The Commission concluded in the *Video Dialtone Reconsideration Order* that video dialtone service offerings by LECs subject to price cap regulation would be subject to the existing price cap rules.<sup>5</sup> The Commission also tentatively concluded, however, that a separate price cap basket for video dialtone services would help to avoid improper cross-subsidization by preventing local telephone companies from offsetting a price reduction for video dialtone service with an increase in rates for other regulated interstate services.<sup>6</sup> The Commission tentatively held that such a basket would protect interstate telephone ratepayers and deter anti-competitive pricing of video dialtone services.<sup>7</sup> The Commission indicated in the *Video Dialtone Reconsideration Order* that it would seek comment on establishing a separate price cap basket for video dialtone services in a supplemental notice as part of the *Price Cap Performance Review*<sup>8</sup> proceeding. We now adopt this Further Notice of Proposed Rulemaking to invite comments on our tentative conclusion. We also seek comment on other revisions to our price cap rules that may be necessary in the event that we affirm our tentative conclusion.

## II. BACKGROUND

### A. Video Dialtone Service

3. Under the two-level regulatory framework established in the *Video Dialtone Order*, a LEC may offer both "basic" and "enhanced" services. The "basic" video dialtone service consists of two elements: (i) a common carrier platform made available to multiple video programmers on a non-discriminatory basis; and (ii) the means by which customers of video programmers can obtain access to any or all video programming offered over the platform.<sup>9</sup>

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cap basket be required for provision of video dialtone service); Consumer Federation of America and National Cable Television Association, Inc., Petition for Rulemaking and Request for Establishment of Joint Board at 10, 17-18 (filed Apr. 8, 1993) (CFA/NTCA Joint Petition); AT&T Comments to CFA/NTCA Joint Petition at 9-10 (filed May 21, 1993) in *Video Dialtone Reconsideration Order*, at para. 200 n.372 (requesting establishment of a separate price cap basket for video dialtone service).

<sup>5</sup> *Video Dialtone Reconsideration Order* at para. 161.

<sup>6</sup> *Id.* at paras. 167, 222-23.

<sup>7</sup> *Id.*

<sup>8</sup> Price Cap Performance Review for Local Exchange Carriers, Notice of Proposed Rulemaking, 9 FCC Rcd 1687, 1694 (1994) (*Price Cap Performance Review Notice*).

<sup>9</sup> The Commission has noted that the basic platform "could include transport, switching, interconnection between the telephone company and the video programmer, and a means of accessing the consumer." Services other than those that are basic or adjunct to the offering of

A carrier must first provide this basic platform before it may use the platform to offer "enhanced" services related to the provision of video programming on a non-common carrier basis.<sup>10</sup> Video dialtone service provided over the basic platform is a common carrier service subject to Title II tariffing and non-discrimination requirements.<sup>11</sup> Our existing safeguards apply to a LEC's provision of enhanced and other non-regulated service over the video dialtone platform.<sup>12</sup> These safeguards include accounting and cost allocation rules to separate enhanced and other non-regulated service costs from regulated service costs, and network disclosure rules that ensure that telephone equipment manufacturers and vendors have adequate notice of changes that could affect the compatibility of their equipment.<sup>13</sup>

4. In the *Video Dialtone Reconsideration Order*, we concluded that video dialtone service would be treated as a new service under the price cap rules because it adds to the range of options available to customers by giving multiple video programmers access to a basic common carrier platform for the first time.<sup>14</sup> We also concluded that consistent with our rules governing the pricing of new services, rates for video dialtone service must be designed to recover the direct costs of providing the service.<sup>15</sup> In addition to the generally applicable rules that specify the cost support that must be submitted with any price cap new service, we set forth specific guidelines for the LECs to follow in developing their rates for video dialtone

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basic service are not permitted on the basic common carrier platform. *Video Dialtone Order*, 7 FCC Rcd at 5810-12 nn.147, 150.

<sup>10</sup> Because the Commission concluded that marketplace forces, rather than governmental action, should determine the precise nature of enhanced video dialtone services, it did not dictate the functions of enhanced video dialtone gateways or other services. For example, the Commission noted, but did not require, that the enhanced video dialtone platform might include customized menus and directories to allow subscribers to select individualized programming and information services. *Video Dialtone Order*, 7 FCC Rcd at 5821 n.146.

<sup>11</sup> *Video Dialtone Order*, 7 FCC Rcd at 5810-12, 5827.

<sup>12</sup> *Id.* at 5828-29; *Video Dialtone Reconsideration Order* at paras. 224-33.

<sup>13</sup> *Video Dialtone Order*, 7 FCC Rcd at 5828-29; *Video Dialtone Reconsideration Order* at paras. 224-33.

<sup>14</sup> *Video Dialtone Reconsideration Order* at para. 206.

<sup>15</sup> See Amendment of Part 69 of the Commission's Rules Relating to the Creation of Access Charge Subelements for Open Network Architecture: Policy and Rules Concerning Rates for Dominant Carriers, Report and Order, Order on Further Reconsideration, and Supplemental Notice of Proposed Rulemaking, CC Docket Nos. 89-79, 87-313, 6 FCC Rcd 4524, 4531 (1991) (*Part 69 ONA Order*), *second further recon.*, 7 FCC Rcd 5235, 5237 (1992) (*Part 69 ONA Reconsideration Order*).

service offerings. Those guidelines, among other things, directed the LECs to include as direct costs of video dialtone service: the costs and cost components associated with the primary plant investment that are incremental costs dedicated to video dialtone service; incremental costs that are associated with shared plant used to provide video dialtone and other services; a reasonable allocation of other costs that are associated with shared plant used to provide video dialtone and other services; costs in accounts other than primary plant accounts that are reasonably identifiable as incremental costs of video dialtone service; and a reasonable allocation of overheads.<sup>16</sup>

### B. The LEC Price Cap Plan

5. Under Section 61.42(d) of the Commission's rules,<sup>17</sup> price cap LECs must divide the access rate elements of their various interstate services among four baskets – common line, traffic sensitive, trunking and interexchange.<sup>18</sup> The aggregate price levels of services grouped within each of the price cap baskets may not exceed the maximum permitted by the price cap index (PCI) applicable to that basket.<sup>19</sup> Services within the traffic sensitive and trunking baskets are further subdivided into separate service categories, which place additional constraints on pricing.<sup>20</sup> The service categories prevent a LEC from offsetting increases in the prices of services within one category by reducing the prices of services in another category

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<sup>16</sup> *Video Dialtone Reconsideration Order* at paras. 217-20 (footnotes omitted).

<sup>17</sup> 47 C.F.R. § 61.42(d).

<sup>18</sup> *LEC Price Cap Order*, 5 FCC Rcd at 6811; *see also* *Transport Rate Structure and Pricing*, 9 FCC Rcd 615, 622-23 (1994) (*Transport Second Report and Order*).

<sup>19</sup> *LEC Price Cap Order*, 5 FCC Rcd at 6811.

<sup>20</sup> *LEC Price Cap Order*, 5 FCC Rcd at 6788; *LEC Price Cap Reconsideration Order*, 6 FCC Rcd at 2679; *Transport Second Report and Order*, 9 FCC Rcd at 622-23. The service categories within the traffic sensitive basket are: (1) local switching; (2) information; (3) database access; and (4) billing name and address. *LEC Price Cap Order*, 5 FCC Rcd at 6811; *see also* *Treatment of Operator Services Under Price Cap Regulation*, Notice of Proposed Rulemaking, CC Docket No. 93-124, 8 FCC Rcd 3655 (1993) (proposing to establish a new service category in the traffic sensitive basket for operator services rates). The service categories in the trunking basket are: (1) voice grade flat-rated transport; (2) audio and video; (3) high capacity and Digital Data Service (DDS); (4) wideband data and wideband analog; (5) tandem-switched transport; and (6) the interconnection charge. *LEC Price Cap Order*, 5 FCC Rcd. at 6811; *see also* *Treatment of Operator Services Under Price Cap Regulation*, 8 FCC Rcd 3655 (1993). Within the high capacity-DDS service category are subcategories for (1) DS1 special access and (2) DS3 special access and DS3 flat-rated transport. *Id.*

of the same basket.<sup>21</sup> There are no service categories in the common line or interexchange baskets.<sup>22</sup>

6. The formula that governs annual adjustments to a LEC's PCIs for the traffic sensitive, trunking, and interexchange baskets consists of three main elements -- an inflation factor, a productivity offset, and exogenous costs.<sup>23</sup> The inflation factor is based on the Gross National Product Price Index (GNP-PI). The productivity offset, which is subtracted from the inflation factor, reflects the amount by which LEC productivity gains are expected to exceed productivity gains in the economy as a whole.<sup>24</sup> The resulting figure is also adjusted for a limited set of exogenous cost changes, generally those attributable to administrative, legislative, or judicial action beyond the carrier's control and not otherwise reflected in price cap calculations.<sup>25</sup> Within each basket, services may be grouped into service categories. Rate changes in any one year are also limited by rate bands. The rate band for each designated service category is computed around the Service Band Index (SBI)

7. The price cap baskets and service categories established by the Commission are designed to balance the competing interests of LECs and their ratepayers.<sup>26</sup> The Commission

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<sup>21</sup> *Transport Second Report and Order*, 9 FCC Rcd at 622-23.

<sup>22</sup> The Commission decided in the *LEC Price Cap Order* that service category subdivisions were not necessary in either the common line basket or the interexchange basket because all of the common line rate elements but one were to be priced according to Commission rules, and only a small amount of interexchange service was subject to price cap regulation. 5 FCC Rcd at 6811.

<sup>23</sup> The formula for the common line basket is slightly different from the formula used to cap the other three baskets. This arises because the actual costs of common line are non-traffic sensitive, but a portion of the cost is recovered through rates that are traffic sensitive. *LEC Price Cap Order*, 5 FCC Rcd at 6787, 6794-95.

<sup>24</sup> The minimum productivity factor for the traffic sensitive, trunking and common line baskets is 3.3 percent, which reflects historical telephone industry productivity growth of 2.8 percent and an annual Consumer Productivity Dividend (CPD) of 0.5 percent, for the three access service baskets. The productivity factor for the interexchange basket is 3.0 percent, matching the factor established for AT&T's interexchange services.

<sup>25</sup> See Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, 5 FCC Rcd 6786 (1990) (*LEC Price Cap Order*), Erratum, 5 FCC Rcd 7664 (Com. Car. Bur. 1990), *modified on recon.*, 6 FCC Rcd 2637 (1991) (*LEC Price Cap Reconsideration Order*).

<sup>26</sup> *LEC Price Cap Order*, 5 FCC Rcd at 6810-11; see also Policies and Rules Concerning Local Exchange Carrier Validation and Billing Information for Joint Use Calling Cards, Second Report and Order, 8 FCC Rcd 4478, 4483 n.68 (1993) (*Billing Name and Address Order*).

intended to give LECs sufficient pricing flexibility as an incentive to be efficient and productive, without subjecting ratepayers to precipitous fluctuations in prices for LEC services or allowing LECs to discriminate against one class of ratepayers at the expense of another class.<sup>27</sup> Moreover, the assignment of services to price cap baskets and service categories is intended to replicate the effect that a competitive market would have on pricing practices.<sup>28</sup> Grouping services with common characteristics, such as similar levels of competition, within the same basket is intended to give the LECs pricing flexibility with respect to comparable services and to restrict the ability of LECs to offset increases for some services with rate decreases for dissimilar services. Price cap LECs receive streamlined tariffing procedures for rate changes that are within the appropriate PCI for the basket and, where applicable, within the service category bands.<sup>29</sup>

### III. DISCUSSION

#### A. Price Cap Basket for Video Dialtone Services

8. We stated in the *Video Dialtone Reconsideration Order* that "video dialtone service does not fit into existing price caps baskets given its unique characteristic of transmitting the video services of multiple program providers to end users on a common carrier basis."<sup>30</sup> We therefore tentatively concluded that "a separate price cap basket for video dialtone would help prevent improper cross-subsidization by preventing local telephone companies from offsetting a price reduction for video dialtone service with an increase in rates for other regulated interstate services."<sup>31</sup> We seek in this proceeding to determine whether affirmation of this tentative conclusion will advance the public interest objectives that underlie our system of price cap regulation and video dialtone service rules. Specifically, we must determine whether the creation of a video dialtone service basket will further the price cap goals of promoting economic efficiency, ensuring reasonable nondiscriminatory rates, and reducing administrative costs.<sup>32</sup> We must also assess whether establishing a separate basket will further the Commission's objectives, articulated in its *Video Dialtone Reconsideration Order*, of facilitating competition in the provision of video services, promoting efficient investment in the national

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<sup>27</sup> *LEC Price Cap Order*, 5 FCC Rcd at 6810-11.

<sup>28</sup> See, e.g., *Price Cap Performance Review Notice*, 9 FCC Rcd at 1694.

<sup>29</sup> In contrast, LECs must file cost support to justify rate changes that fall outside the constraints applicable to baskets or service categories. See Section 61.49 of the Commission's rules, 47 C.F.R. § 61.49; see also *Transport Second Report and Order*, 9 FCC Rcd at 627 n.3.

<sup>30</sup> *Video Dialtone Reconsideration Order* at para. 222.

<sup>31</sup> *Id.*

<sup>32</sup> *Price Cap Performance Review*, 9 FCC Rcd at 1695.

telecommunications infrastructure, and fostering the availability of new and diverse sources of video programming to the public.<sup>33</sup> We invite parties to comment on whether and how establishment of a separate price cap basket for video dialtone service will advance these objectives.

9. We indicated in the *Video Dialtone Reconsideration* proceeding our tentative agreement with proponents of a separate price cap basket that this approach would help to ensure that telephone ratepayers do not improperly subsidize video dialtone service.<sup>34</sup> Parties also have contended that a separate basket is needed to protect cable operators and other providers of multi-channel video services from potential anti-competitive actions by LECs. They claim that LECs otherwise will have the incentive and ability to offset price decreases for video dialtone service with price increases for other regulated interstate services. We invite parties to comment on our tentative conclusion and to address specifically our concern that a separate basket is needed to address our cross-subsidy and competitive concerns.

10. The Commission previously has based its decision to create a separate price caps basket on an analysis of whether the service possesses characteristics, such as technical differences or the level of competition in the service markets, that were not shared by services in the existing baskets. The Commission concluded in the *LEC Price Cap Order*, for example, that it was necessary to establish a separate price cap basket for interexchange services because such offerings were found to be "fundamentally different" from special access services.<sup>35</sup> In addition, the Commission noted that:

[p]lacing two very different services, with different sets of customers, in the same basket is a result [the Commission has] attempted to avoid due to the cross subsidy issues that might arise.<sup>36</sup>

11. In reaching our tentative conclusion that a separate basket is needed for this service, we noted that the technical and competitive characteristics of video dialtone are not similar

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<sup>33</sup> *Video Dialtone Reconsideration Order* at para. 3.

<sup>34</sup> See *id.* at para. 157 (joint petition for rulemaking filed by the Consumer Federation of America and National Cable Television Association).

<sup>35</sup> *LEC Price Cap Order*, 5 FCC Rcd at 6812.

<sup>36</sup> *Id.*



to any services in our existing price cap baskets. We invite parties to comment on this tentative finding that video dialtone offerings are different from, and compete for different customers than, services in the existing price cap baskets.<sup>37</sup>

12. As we stated in the *Video Dialtone Reconsideration Order*, video dialtone is but the first of what we expect to be an array of broadband services.<sup>38</sup> As discussed above, our current price cap rules group services with similar characteristics in the same basket. Consequently, it may be desirable to group broadband services whose technical or other characteristics, such as the availability of competitive alternatives, are similar to video dialtone service in the same price cap basket with video dialtone service. Such a requirement may increase the pricing flexibility of LECs with respect to broadband services, such as video dialtone, while restricting their ability to offset price changes for such services with price changes for dissimilar services. We request comment on whether the Commission should establish a new price cap basket that would include not only video dialtone services, but also other broadband, transport-related services. Parties favoring this approach should describe the criteria that should be used to determine the services that should be included in such a basket.

13. LECs have claimed in our video dialtone rulemaking that the rates for this service should be included within the existing price cap baskets. BellSouth, for example, asserted in its comments in the *Video Dialtone Reconsideration* proceeding that video dialtone is a transport service that will fit comfortably into the existing price cap baskets depending upon how the service is offered.<sup>39</sup> We invite commenters who advocate inclusion of video dialtone service in an existing price cap basket to identify the specific basket and, if applicable, service category in which the rates for this service should be placed and to explain the basis for their proposal. Commenters favoring this alternative should also show that video dialtone service possesses characteristics that are similar to the services that are currently included in the basket they propose, including the availability of competitive alternatives. Furthermore, the commenters should address the concern that inclusion of video dialtone service in an existing basket would permit LECs to cross-subsidize their entry into video service improperly and to engage in anti-competitive practices.

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<sup>37</sup> AT&T notes in its comments to the *Price Cap Performance Review Notice*, for example, that the "potential competitive nature" of the video dialtone services that are the subject of recently granted or pending Section 214 applications may warrant a separate price cap basket for these services. See AT&T Comments at 40 n.59.

<sup>38</sup> *Video Dialtone Reconsideration Order* at para. 188.

<sup>39</sup> BellSouth Comments at 14.

## B. Implementation Issues

### 1. The Productivity Factor

14. If the Commission decides to create a separate video dialtone basket, it will be necessary to determine whether the price cap formula that is used to adjust the PCIs for the other LEC interstate access service baskets should be used for the video dialtone basket. In particular, the Commission will have to address whether the same productivity factor (currently 3.3 percent or 4.3 percent) should be used. Selection of a reasonable productivity factor for a video dialtone basket is crucial to ensuring that price cap regulation of this service would be efficient and fair to LECs, their customers, and consumers. If the productivity factor is too low, prices will be too high, depressing demand from consumers and leading to inefficiently low levels of traffic. If the productivity factor is set too high, investment may be discouraged because carriers may conclude that investment of capital in other ventures and services is more attractive than providing video dialtone service.

15. In the *LEC Price Cap Order*, the Commission determined that the GNP-PI does not fully reflect that the LECs' higher than average growth in productivity had produced lower than average telephone prices, relative to inflation. We therefore concluded that a productivity factor offset must be included in the price cap formula to ensure that rates continued to decline in relation to the GNP-PI. Our selection of a 3.3 percent productivity factor for the interstate access baskets was based largely upon two Commission staff studies investigating the extent to which LEC productivity in the provision of interstate services historically had outperformed the economy as a whole. A short term study examined productivity trends in interstate access from 1984 through 1990; a long term study covered interstate charges generally for the years 1930 through 1989. A 0.5 percent Consumer Productivity Dividend (CPD) was added (to arrive at a productivity factor of 3.3 percent) to ensure that the first price cap productivity gains would be assigned to customers in the form of lower rates. As noted above, we selected a factor of 3.0 percent for the interexchange basket, because that was the factor we previously had computed for AT&T's interexchange services. We also note that we recently declined to include a productivity offset in the price cap formula applicable to cable television rates.<sup>40</sup>

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<sup>40</sup> *Implementation of Section of the Cable Television Consumer Protection and Competition Act of 1992 -- Rate Regulation*, 9 FCC Rcd 5760 (1994). In the *Cable Order*, the Commission determined that "a productivity offset should be based to the extent possible on observed efficiency gains experienced by the cable industry." *Id.* at 5761. The Commission found that the only study submitted in the docket that "purported" to provide an economic analysis in support of a productivity offset factor for cable service was not based on an analysis of costs or productivity in the cable industry. The Commission therefore concluded that the record did not provide an adequate factual basis for the incorporation for a productivity offset in the price cap governing cable service rates. *Id.*

16. We invite parties to comment on the appropriate formula to be used to adjust the PCI for a video dialtone price cap basket in the event we affirm our tentative conclusion to require a separate basket. Parties advocating the use of the same formula that is applied to other baskets should explain why that approach is reasonable since the historical data upon which the current minimum productivity factor is based did not include information concerning the LECs' provision of video dialtone service. Parties advocating a different formula (e.g., formulas that do not include a productivity factor) should explain the basis for their proposed formulas. Advocates of either approach should address whether the Commission should include a CPD in setting the productivity factor for a video dialtone basket. We also request comment on whether adjustments might be needed to the other price cap baskets arising from the price cap LECs' more efficient use of common plant and shared expenses between video dialtone and pre-existing services. Such adjustments might include, for example, changes in the productivity factors for the other price cap baskets.

## 2. Setting the Initial Price Cap

17. If we create a separate price cap basket for video dialtone service, we must decide how to set the initial price cap for the basket. In the *LEC Price Cap Order*, the Commission determined that the July 1, 1990 LEC interstate access rates (adjusted downward to implement the 11.25 percent industry rate of return adopted by the Commission on the same day as the LEC price cap rules) were the best set of rates from which to initiate price cap indexing. In reaching its decision, the Commission stated that the July 1, 1990 rates were the culmination of a six-year history of developing, refining, and overseeing the Commission's administration of rate of return regulation. The Commission noted that these rates were the result *inter alia* of a revised system of tracking costs (i.e., the Uniform System of Accounts (USOA)), cost allocation procedures to separate nonregulated costs from the combined regulated and nonregulated costs recorded in USOA accounts, and related reporting requirements. The Commission also noted that the rates reflected a tariff review process that ensured that the Common Carrier Bureau had usable and reliable cost support in reviewing a LEC's annual access charge revisions. As a result of this process, the Commission decided that these rates in general provided the "most reasonable basis from which to launch a system of price cap regulation."<sup>41</sup>

18. We tentatively conclude that in the absence of a long history of regulatory review and oversight of the video dialtone rates, the best approach for establishing the initial rates to be included in a video dialtone basket would be to apply our existing rules for new services. As noted *supra*, the Commission has already determined that for purposes of the initial

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<sup>41</sup> *LEC Price Cap Order*, 5 FCC Rcd at 6814; see also *Price Cap Performance Review Notice*, 9 FCC Rcd at 1696 (as part of its fourth year review of the LECs' performance under price cap regulation, the Commission requested comment on "whether a one-time change in the LECs' price cap index should be required.").

offering, video dialtone services are subject to the new services rules. Under these rules, new services are excluded from price cap baskets and indexes when the services are first introduced. The new services are incorporated into baskets and reflected in the price cap indexes at the first annual price cap filing following the calendar year in which the new service has been offered, a period of between 6 and 18 months after the introduction of the new service, depending upon the timing of the introduction of the new service.<sup>42</sup> Consistent with our treatment of other new services under the LEC price cap regulation, we believe that video dialtone services should be folded into the video dialtone basket at the first annual price cap filing following the calendar year in which the new service is first offered. Further, consistent with the approach we followed in initializing the indexes for the existing price cap baskets, we recommend that the price cap index and the actual price index for a new video dialtone basket be assigned an initial value of 100 prior to adjustment for inflation and productivity, corresponding to the rates in effect just prior to the effective date of the annual filing in which the video dialtone basket is introduced.<sup>43</sup>

19. We invite comment on our tentative conclusion regarding the method the Commission should use for setting the initial rates for a new price cap basket for video dialtone.

### 3. Service Category Bands

20. The Commission concluded in the *Video Dialtone Reconsideration Order* that the basic video dialtone platform is a form of interstate access to the extent it is used to route interstate video programming to end users.<sup>44</sup> The Commission further stated in the *Video Dialtone Reconsideration Order* that service offered over the basic video dialtone platform could potentially include transport, switching, interconnection between the telephone company and the video programmer, and a means of accessing the consumer.<sup>45</sup> Although the Commission indicated that it would treat video dialtone as a switched access service, it declined to prescribe new rate elements for video dialtone and, instead, directed telephone companies seeking to offer video dialtone service to file petitions for waiver of Part 69 prior to the establishment of a permanent video dialtone rate structure.<sup>46</sup> We seek comment on whether video dialtone

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<sup>42</sup> *Id.* at 6825; *LEC Price Cap Reconsideration Order*, 6 FCC Rcd at 2693.

<sup>43</sup> See, e.g., Section 61.42 of the Commission's Rules, 47 C.F.R. § 61.42(d).

<sup>44</sup> *Video Dialtone Reconsideration Order* at para. 195.

<sup>45</sup> See note 9 *supra*.

<sup>46</sup> *Id.* at paras. 196-98 n.368, citing Provisions of Access for 800 Service, 4 FCC Rcd 2824, 2833 (1989) (permitting carriers to receive Part 69 waivers to establish separate unbundled subelements for 800 data base access and vertical features prior to the establishment of a permanent rate structure); Southwestern Bell Telephone Company, Petitions for Waiver of

service offerings may require establishment of separate service categories if the Commission established a separate video dialtone basket. Commenters proposing establishment of such service categories should discuss in detail why further subdivision of a video dialtone services price cap basket is necessary or desirable.

21. Under the price cap rules, pricing bands apply to each service category. The pricing bands limit the amount by which the carrier can raise or lower a rate without making a special showing. Tariff filings that propose rates within the pricing bands (and at or below the price cap for the basket) are reviewed on a streamlined basis, i.e., on 14 days' notice, with a presumption of lawfulness. Above-band rates are filed on 90 days' notice and must be accompanied by a showing of substantial cause. Below-band rates are filed on 45 days' notice and must be accompanied by a showing that the rates cover the average variable costs and are otherwise just, reasonable, and nondiscriminatory.<sup>47</sup> Pricing bands are intended to protect ratepayers from substantial and precipitous changes in services rates, and to prevent the LECs from engaging in predatory pricing and other anti-competitive practices.<sup>48</sup> Commenters opposing the subdivision of a new video dialtone basket into service categories subject to pricing bands should discuss whether some other regulatory mechanism is needed to limit a LEC's ability to raise or lower rates within the basket.

#### 4. Sharing Issues

22. Under price cap regulation, a LEC is required to adjust its PCIs downward if its rate of return for the preceding calendar year exceeds 12.25 percent or, in some cases, 13.25 percent,<sup>49</sup> and may adjust its PCIs upward if its rate of return for that period falls below 10.25 percent.<sup>50</sup> The sharing and lower end adjustment mechanisms are intended to compensate for

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Part 69 of the Commission's Rules, 6 FCC Rcd 6095, 6098 (1991) (allowing carriers to receive Part 69 waivers to offer Line Identification Database (LIDB) services prior to the establishment of a permanent rate structure).

<sup>47</sup> *LEC Price Cap Order*, 5 FCC Rcd at 6788, 6822-24.

<sup>48</sup> *LEC Price Cap Order*, 5 FCC Rcd at 6788, 6811, 6813-14; *LEC Price Cap Reconsideration Order*, 6 FCC Rcd at 617.

<sup>49</sup> The 12.25 benchmark applies to LECs that operate with a 3.3 productivity offset. LECs that elect the more challenging 4.3 productivity offset do not have to make a sharing adjustment unless their rate of return exceeds 13.25 percent. *LEC Price Cap Order*, 5 FCC Rcd at 6788, 6801-2.

<sup>50</sup> For example, under the sharing adjustment, a LEC that uses the 3.3 percent productivity offset must share with its customers half of its earnings between 12.25 percent and 16.25 percent, and all of its earnings in excess of 16.25 percent. Under the lower end adjustment, a LEC that posts earnings below 10.25 percent is entitled to adjust its rates upward to target

the possibility of an error in the choice of the productivity factor and performance variations among the different LECs.<sup>51</sup> The sharing and lower end adjustments are made as one-time adjustments to a single year's rates.<sup>52</sup>

23. The Commission concluded in the *LEC Price Cap Order* that a carrier's sharing obligation would be based on its total interstate earnings.<sup>53</sup> The customer's share plus interest is returned through a one-time reduction in the PCI for the next rate period, calculated in the same manner as other exogenous changes in the formula.<sup>54</sup> The Commission rejected commenters' arguments that basing sharing on total interstate earnings would provide incentives for LECs to engage in cross-subsidization among service baskets and that sharing should therefore be based on per-basket or per-service earnings. The Commission reasoned that in view of the limitations imposed by the price cap indexes, sub-indexes, and service categories and the requirement that sharing be allocated among the baskets on a cost-causative basis, the commenters' concerns were "at best speculative."<sup>55</sup>

24. If we affirm our tentative conclusion to establish a separate price cap basket, we believe that we should consider whether the costs and revenues associated with this basket should be included with those from the other baskets to compute a LEC's interstate earnings. We have previously noted our objective of ensuring that video dialtone costs are not recovered through charges for other interstate access services.<sup>56</sup> Our decision to adopt a uniform sharing mechanism for all baskets was based in part on our decision to adopt a unitary productivity offset,<sup>57</sup> and we have raised the issue here of whether the productivity factor set forth in the

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earnings to 10.25 percent (the "lower end adjustment") in the following year. *Id.*

<sup>51</sup> See, e.g., *Price Cap Performance Review Notice*, 9 FCC Rcd at 1689.

<sup>52</sup> *LEC Price Cap Order*, 5 FCC Rcd at 6803; see also *LEC Price Cap Reconsideration Order*, 6 FCC Rcd at 2691 n.166.

<sup>53</sup> *LEC Price Cap Order*, 5 FCC Rcd at 6805; *LEC Price Cap Reconsideration Order*, 6 FCC Rcd at 2677.

<sup>54</sup> *LEC Price Cap Order*, 5 FCC Rcd at 6801; *LEC Price Cap Reconsideration Order*, 6 FCC Rcd at 2686; see also Section 61.45(d)(4) of the Commission's Rules; *1992 Annual Access Tariff Filings*, 7 FCC Rcd 4731, 4733 (Com. Car. Bur. 1992) (The Common Carrier Bureau "require[d] that LECs allocate their [sharing] adjustments to all price cap baskets based on the proportion of total revenue in each basket to total interstate revenue.").

<sup>55</sup> *LEC Price Cap Reconsideration Order*, 6 FCC Rcd at 2680.

<sup>56</sup> *Video Dialtone Reconsideration Order* at para. 195.

<sup>57</sup> *LEC Price Cap Order*, 5 FCC Rcd at 6805.

*LEC Price Cap Order* should be applied to video dialtone.<sup>58</sup> While we rejected arguments to exclude LEC interexchange earnings from the calculation of total interstate earnings that define LEC sharing obligations, we did exclude the earnings and costs of services excluded from the price cap plan from such calculations.<sup>59</sup>

25. We request comment on whether the costs and revenues associated with video dialtone should be included in the calculation of a LEC's interstate rate of return for purposes of the sharing and low end adjustment mechanisms. Inclusion of these costs and revenues will change a LEC's earnings whenever the return earned on video dialtone is different from the return on other interstate services. In some circumstances, the change may be significant enough to move a LEC's total interstate earnings into or out of the sharing zones or into or out of the low end adjustment area. In view of these different possible outcomes, we seek comment on whether our price cap and video dialtone public interest goals would be served by including the costs and revenues of video dialtone service with the costs and revenues of other price cap baskets in calculating a LEC's interstate earnings for purposes of the sharing and low end adjustment mechanisms. More generally, we seek comment on whether our existing and proposed price cap mechanisms, including a separate video dialtone basket, fulfill our commitment "to implement[] video dialtone in a manner that does not subject basic telephone ratepayers to unreasonable rate increases or allow improper cross-subsidization."<sup>60</sup>

#### IV. PROCEDURAL MATTERS

##### A. Ex Parte Rules -- Non-Restricted Proceeding

26. This is a non-restricted notice and comment rulemaking proceeding. *Ex parte* presentations are permitted, except during the Sunshine Agenda period, provided they are disclosed as provided in the Commission's rules.<sup>61</sup>

##### B. Regulatory Flexibility Act

27. We certify that the Regulatory Flexibility Act of 1980 does not apply to this rulemaking proceeding because if the proposed rule amendments are promulgated, there will not be a significant economic impact on a substantial number of small business entities, as defined by Section 601(3) of the Regulatory Flexibility Act. Carriers subject to price cap

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<sup>58</sup> See *supra* paras. 11-13.

<sup>59</sup> *LEC Price Cap Reconsideration Order*, 6 FCC Rcd at 2681-82.

<sup>60</sup> *Video Dialtone Reconsideration Order* at para. 162; see also *id.* at para. 217 (recognizing need to take into account all costs resulting from a carrier's decision to provide video dialtone).

<sup>61</sup> See generally 47 C.F.R. §§ 1.1202, 1.1203, and 1.1206(a).

regulation for local exchange access services affected by the rule amendments under consideration generally are large corporations or affiliates of such corporations. The Secretary shall send a copy of the Notice of Proposed Rulemaking, including the certification, to the Chief Counsel for Advocacy of the Small Business Administration in accordance with paragraph 603(a) of the Regulatory Flexibility Act, Pub. L. No. 96-354, 94 Stat. 1164, 5 U.S.C. 601 *et seq.* (1981).

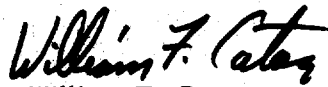
### C. Comment Filing Dates

28. Pursuant to applicable procedures set forth in Sections 1.415 and 1.419 of the Commission's Rules,<sup>62</sup> interested parties may file comments on or before April 17, 1995, and reply comments on or before May 17, 1995. To file formally in this proceeding, parties must file an original and four copies of all comments, reply comments, and supporting comments. If parties want each Commissioner to receive a personal copy of their comments, parties must file an original plus nine copies. Comments and reply comments should be sent to the Office of the Secretary, Federal Communications Commission, Washington, D.C. 20554. Parties should also file one copy of any documents filed in this docket with the Commission's copy contractor, International Transcription Service, Inc., Room 246, 1919 M Street, N.W., Washington, D.C. 20037. Comments and reply comments will be available for public inspection during regular business hours in the FCC Reference Center, Room 239, 1919 M Street, N.W., Washington, D.C. 20554.

## V. ORDERING CLAUSE

29. Accordingly, IT IS ORDERED that, pursuant to Sections 1, 4, 201-205, 215, and 218 of the Communications Act of 1934, as amended, 47 U.S.C. §§ 151, 154, 201-205, 215, 218, a NOTICE IS HEREBY GIVEN OF the rulemaking described above and that COMMENT IS SOUGHT on the issues contained therein.

FEDERAL COMMUNICATIONS COMMISSION



William F. Caton  
Secretary

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<sup>62</sup> 47 C.F.R. §§ 1.415, 1.419.